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SENSITIVE
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TAGS: ECON EFIN ETRD PGOV PREL NZ
SUBJECT: NEW ZEALAND'S RESERVE BANK BALANCING ACT - TRYING
TO KEEPING BOTH INFLATION AND THE KIWI DOLLAR IN CHECK

REF: WELLINGTON 351

¶1. (SBU) SUMMARY: On June 11, in what was initially seen as a surprising move, the Reserve Bank of New Zealand (RBNZ) begun to intervene for the first time in 20 years in the international currency markets in an attempt to stem the rapid appreciation of the Kiwi dollar. Many critics say the move was very risky, as New Zealand's limited monetary reserves can not compete with huge international hedge funds drawn to New Zealand's high 8 percent official cash rate (OCR -- the Bank's interbank loan interest rate.) Ironically, it is RBNZ's efforts to keep the housing market and other inflationary pressures under control by setting the OCR rate at record rates that is simultaneously driving the value of the Kiwi dollar up. The conflicting aims of RBNZ monetary policy - low inflation and lower exchange rate - are leading the Bank into uncharted territory whose outcome is uncertain. If the Bank's actions fail to produce the desired results of lower housing costs and lower exchange rates it may find itself at the limits of its monetary tools. Not surprisingly, many economists are calling for other means to drive down inflation and interest rates, but politically unpopular proposals such as capital gains on property would be hard for the Labour Government to push through. END SUMMARY.

¶2. (U) In what some analysts see as risky, on June 11 the Reserve Bank of New Zealand (RBNZ) intervened for the first time in 20 years in international currency markets in an attempt to stem the rapid appreciation of the Kiwi dollar. The move shocked currency markets, and initially the Kiwi dollar fell nearly US2 cents from a 22-year high of US76.39 cents, to trade under US75 cents. This intervention followed the raising of the official cash rate (OCR) by the Reserve Bank by 25 basis points to a record 8 per cent three weeks ago. (It is now one of the highest rates in the developed world, see reftel.)

¶3. (U) Initial business reaction to the intervention was mainly supportive, particularly among exporters hoping for a lower Kiwi dollar. Some analysts, however, pointed out that the move was a risky one. The bank sold approximately NZ$500 million out of a total estimated reserve of NZ $3.5 billion. The analysts warned that New Zealand's high interest rates would remain attractive for investors, and it would be difficult for the Bank to use its relatively small NZ reserves to outbid those international hedge fund managers who believe the currency is now undervalued. .

¶4. (U) These concerns may already have been borne out. The June 11 intervention had only a short lived success in decreasing upward pressure on the NZ$ exchange rate. A second, unconfirmed intervention on the morning of June 18 (size unknown but rumored smaller than the first) saw the exchange rate fall from about US75.5 cents to US75 cents. Taking advantage of the local time difference, the action was carried out while the NZ markets were the only ones open in order to dampen unnecessary speculation. But by the time the New York markets closed, the NZ$ had returned to its pre-intervention rate. Apparently, immediately after both interventions foreign investors increased their purchase of NZ$ assets. (NB: In the past, Japanese companies and individuals have been the most active investors in NZ$ assets.)

¶5. (U) While the first intervention may have indicated to some market watchers a glass ceiling of US76 cents, the second intervention occurred just below 75.5US cents, which some market analysts believe must be the true set level. Regardless what the Reserve Bank sees as the breaking point, NZ exporters are complaining that even the current rate (or lower) is too high an exchange rate burden for them to maintain competitiveness overseas. Though the RBNZ is legally independent in its mandate to set monetary policy some politicians have expressed surprise and annoyance at the Bank's lack of prior consultation. Prime Minister Clark and Minister of Finance Cullen have said publicly that they did not have prior knowledge of either intervention and have continued to remain publicly neutral to insure the continued independence of the RBNZ.

¶6. (U) COMMENT: Currently RBNZ Governor Bollard has not ruled

out further interventions or further increases in the OCR rate and analysts are laying odds on yet another rate increase sometime this year. Early reactions from investors and rising commodity prices suggest that the NZ$ will appreciate again and the RBNZ will be forced to choose between modifying the exchange rate and the interest rate. If these conflicting goals remain unresolved RBNZ may enter into an unsustainable cycle in which it is neither able to keep inflation within the target band (i.e., between one and three per cent) nor affect the appreciating NZ$. The present balance between the two objectives is delicate and could tip in an unwanted direction as a result of actions by officials within NZ or by international investors. END COMMENT.
MCCORMICK